Testimony of Wyoming Governor Jim Geringer
Speaking on Behalf of the *National Governors Association*
Regarding Sales Tax and Remote Internet Sales

Delivered to the U.S. Senate
Committee on Commerce, Science, and Transportation
The Honorable John McCain, Chairman
Full Committee Hearing on Remote Taxation

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Chairman McCain, Senator Hollings, and members of the Commerce Committee, thank you for your invitation to address issues of state and local taxation authority on behalf of the National Governors Association. I am here today both as the Governor of Wyoming and as the co-chair of the E-Governance Task Force for the National Governors Association.

The hearing notice on your Committee's web page indicated that the purpose of this hearing is "whether Congress should ***allow*** states to require all remote sellers to collect and remit sales taxes on deliveries into that state, provided that states and localities dramatically simplify their sales and use tax systems." I suggest Mr. Chairman, that the issue is not whether the Congress should ***allow*** states and local governing bodies, but whether the Congress should ***enable*** such actions. The answer is "yes."

Since their initial meeting in 1908 to discuss interstate water problems, the Governors have worked through the National Governors Association to deal collectively with issues of public policy and governance. The Association's ongoing mission is to provide a bipartisan forum to help shape and implement national policy and to solve state problems. Today we ask your participation as we begin the process of simplification of taxation at the state, local and federal levels of government.

There's an old saying that "he who defines the issue wins the argument." Part of our work today then, is to decide who has the responsibility and authority to implement new approaches to tax and revenue solutions in the age of the New Economy. I submit that taxation is and should be, the primary responsibility of the states. Preservation of state and local sovereignty is the cornerstone of our government.

Today's Situation

Congress, the states and local governments need to function in the new economy without hindering its continuing expansion. Our economy is changing in fundamental ways and much more rapidly than government's ability to react to it, particularly with regard to taxation.

Electronic commerce is not new. When Marconi invented the telegraph, when Alexander Graham Bell invented the telephone, they initiated electronic commerce. Nobody suggested then that there was something unique that ought to lead the federal government to prohibit the states from imposing taxes on transactions conducted using these new industries or later ones such as fax machines.

Likewise, the "New Economy" is not new. It's just more noticeable. It has taken many of our traditional approaches to governing and service delivery by surprise. Each of us in our respective states wants a piece of the new economy and all that it implies – innovation, productivity, enhanced opportunity and income. Technology and globalization are changing the rules in the economy and the traditional domains of federal, state and local governments, particularly in tax and revenue systems.

Our citizens have become so accustomed to access to the Internet for business transactions that they now expect the same from government programs and services. They want to make purchases and to access services independently of time and place. Our citizens want government to be more accountable and responsive to their needs. That expectation has led to more programs being brought back to the states.

That's what citizens want. Now, what do our businesses want? They want uniformity, particularly when it comes to tax and revenue systems. In order to be competitive, businesses don't want to accommodate the existing patchwork quilt of state laws, regulations and tax programs. How can they achieve uniformity? They might ask the states to develop a uniform approach to taxation, or go to the federal government to ask for uniform standards or a federally imposed tax. Another option would be to not have any tax on any transaction. What we have today is a blend of all – some transactions with a patchwork quilt of laws and regulations, some with simplified taxes and, the newest one, some with no tax at all. The no-tax-at-all transactions are very appealing, both to the on-line retailer and to the on-line customer. This last category is the result of the Internet Tax Freedom Act, which is currently being interpreted to allow any transaction to be conducted electronically and thus avoid the collection of state or local sales and use taxes.

The Internet Tax and Freedom Act

The Internet Tax Freedom Act (P.L. 105-277) was passed in October 1998 to provide the new electronic commerce industry with short-term protection from a burdensome and discriminatory system of state and local taxation. In March 1998, one of the primary sponsors, Rep. Cox (California) held a news conference to announce the support of the National Governors Association, the U.S. Conference of Mayors, the National Conference of State Legislatures, the National Association of Counties, and the National League of Cities for the legislation. Several changes had been made to ease state and local government concerns, including: shortening the moratorium to three years; providing for what was seen as a targeted moratorium instead of a blanket prohibition on all Internet-related taxes; and creating a temporary commission to study the complex state and local tax issues relating to electronic commerce.

State Revenue Sources Focus on Sales Tax

The National Conference of State Legislatures indicates that states collect revenue from three primary sources: sales tax, income tax and property tax. The sales and use taxes dominate, representing anywhere from 27 to 45 percent of state revenues in the 45 states and the District of Columbia that impose transaction taxes. Collectively, approximately 40 percent of all state revenues come from sales and use taxes. Similarly, our cities and other local governing bodies obtain significant revenue from local option taxes.

Our states through our legislatures have figured out how to cut $25 billion worth of taxes over the course of the last decade. How we have cut those taxes has been different in every state, because the people and businesses of each state have different needs and priorities. Many states have shifted reliance away from property tax and broadened (while reducing the rate) the sales tax base in order to provide a much fairer system to invest in public education.

The federal government is empowered to regulate interstate commerce, but it would be unwise to usurp the most basic rights reserved to the states as to how they may or may not raise, or lower, revenues.

State Spending Patterns Focus on Children

Taxes finance the highest priority programs for state and local government. The latest survey of state spending patterns shows that states' highest single priority for spending is education, followed by health care and family services. In Wyoming, nearly 90 percent of our budget is allocated to four main areas: education, health, family services and public safety. Any tinkering with our primary source of income will dramatically affect our top spending programs, particularly those that affect children. Actions or even specific inactions on tax issues by the Congress then, can and will dramatically affect our Wyoming priorities.

Federal Revenue

Contrasted to the states, the federal government generates revenues almost exclusively from income tax. That makes decisions easy from your Congressional point of view. No harm, no foul. No tax, no problem, since no federal revenue comes from sales or use taxes. Our state and local taxes differ by the choices of those who are governed. Five states do not impose any sales tax. A different number of states do not impose an income tax. My message is simple: the Congress should not dictate an absolute pre-emption of state prerogatives on tax issues. You can and should enable the states to come up with their own approach that will lead to uniformity.

Tax Simplification Criteria

The states have already begun to cooperate to simplify state and local tax systems. Restructuring will enable citizens and businesses to understand which level of government imposes taxes and which provides services. We can and will craft a simplified tax structure that is close to the people, fair to both businesses and customers and equally applicable to all transactions.

Any remedy must be equitable, uniform and non-discriminatory. Proper authority of the states must be preserved. Tax policy should not play favorites, whether between and among states or between and among economic activities. Education, health and public safety issues should not be put at risk.

Tax and revenue systems for the new economy should be cost-effective and customer-friendly, afford flexibility in how standards are met and provide transition as states and locals adapt. Today 7,500 different state and local tax jurisdictions are a nightmare for the private sector. Given this mish-mash, federal standards might be appropriate. However, if we are to lower the cost of tax administration as well as of doing business, we need local innovation. That tips the scale toward state responsibility. The solution rests with *nationally developed* standards, not *federally mandated* systems.

Federal Internet Taxes

No one has clean hands when it comes to electronic transaction taxes. While states have been precluded from taxing electronic transactions, the federal government imposes many federal taxes on Internet transactions or businesses, including excise taxes as well as individual and corporate income taxes. The airline ticket tax increase was a critical part of the Balanced Budget Act of 1997, a tax that was increased again last year. No member offered an amendment to exempt from those federal taxes, domestic or international tickets purchased on the Internet, perhaps because such an exemption would have accelerated the migration of ticket purchases to the Internet. That might have eroded a critical source of revenues to the Airport and Airway Trust Fund. Airport and aviation safety in this country and around the world are dependent upon a reliable source of trust fund revenues. Today, Northwest Airlines reports that 65 percent of its customers use E-tickets with little thought given to the taxes that are collected. Do consumers have to pay a federal excise tax when buying tires, airline tickets, liquor or cigarettes over the Internet? Should we propose federal legislation to not tax the income of any person or corporation which makes its money over the Internet as an incentive to boost Internet activity?

Fair is fair. No state taxes, no federal taxes.

Avoiding Unintended Consequences

The argument that Internet-based fledgling businesses need to be nurtured is not a relevant argument. Electronic commerce has become a mature and important part of the U.S. and international economy. Since the moratorium imposed three years ago, much has come to light on the intended as well as the unintended consequences of the Act. The most significant unintended consequence is that traditional business transactions that are taxable today can completely avoid paying taxes in the future simply by setting up an electronic means to complete a transaction.

Any extension of the Internet Tax Freedom Act must modify the definition of Internet access as contained in the Act. Internet and electronic commerce technologies are experiencing a convergence and becoming indistinguishable from other related communications technologies and media.

The Act protects against the imposition of new tax liability for consumers and vendors involved in commercial transactions over the Internet, including the application of discriminatory tax collection requirements imposed on out-of-state businesses through interpretations of 'nexus.' It also protects from taxation, for the duration of the moratorium, goods or services that are sold exclusively over the Internet with no comparable offline equivalent.

This effectively allows a broad range of content and other services to be bundled with Internet access and to potentially be considered as protected under the prohibition on the imposition of new taxes on Internet access. The range of content, services and even goods that can be bundled with Internet access is virtually unlimited. It includes all manner of printed material, video material, voice communications and other services. As the Internet technology converges with services such as telecommunications and cable television, it will become increasingly difficult to distinguish one from another. Today, one out of every 33 international long distance calls is handled over the Internet. A draft report from Geneva last week projects this level to increase from 3 percent today to between 25-40 percent over the next five years. Yet, different service providers could be subject to widely different tax regimes because of the intervention of the Internet Tax Freedom Act.

The Need for Simplification

The states recognize the problem of unequal taxation between in-state merchants and out-of-state merchants, nearly all of whom now use the Internet for a variety of business practices.

In-state merchants who must collect sales/use taxes are at a disadvantage with merchants who transact remote or electronic sales. It's not that the remote or electronic sale is exempt. It is not. Every state that levies sales taxes requires a use tax to be paid if a customer purchase is made on-line or out of state. It is a consumption tax on the consumer, not the vendor. Under current legal standards, a state may only impose sales and use tax *collection* requirements on sellers with a physical presence, or nexus, in the state whether the transaction is over the Internet or not. This means that remote sellers (i.e., sellers outside the state without a physical presence in the state) are able to fully exploit the market in that state – whether by mail, telephone or the Internet – without being required to collect or remit tax on their sales into the state. Sellers that are physically present in the state are required to collect and remit the tax.

The remote merchants are quick to point out that they have to charge shipping and handling and that cancels their advantage over the in-state merchants. That ignores the fact that in-state vendors have already included shipping and handling in their pricing. The in-state merchant not only has to charge and collect the tax but is also responsible for reporting and remitting it and becomes liable for the tax if an audit indicates inadequate collection and remittance. We fully support unfettered interstate commerce but as a matter of basic fairness, similar transactions of goods and services should be treated similarly no matter what means are used to effect the transaction.

Not collecting the use tax on electronic transactions would be an incentive for merchants to use electronic or Internet transactions. States are concerned that Congress' actions or inaction could lead to accelerating the erosion of sales and use tax revenues as the nature of the retail industry evolves. We have learned that one of the nation's largest retailers has entered into an agreement with one of the nation's largest e-tailers. This arrangement could permit a means to avoid sales taxes. For example, Mr. Chairman, someone in Arizona might wander into a store, pick out a nice pair of Levis, and instead of pulling them off the rack and paying for them at the counter, might now use an in-store Internet kiosk to place an order. Then he could go to the counter and pick up his purchase with no liability for state or local tax, since under the Internet Tax Freedom Act definition, it would be a remote sale. Under such a system, one can imagine just how long it would take for every brick and mortar retailer in America to migrate to some form of in-store system simply to compete.

If such a scenario were to play itself out, state sales and use tax systems would become obsolete and inefficient for raising revenue for the state and local governments. While the prospect of no taxes at all is certainly appealing, we are prepared to offer a more pragmatic alternative.

The definition of discriminatory taxes contained in the Act provides that certain activities when performed by an Internet service provider on behalf of a retailer will not be considered in determining substantial nexus for tax collection purposes. When enacted as part of a short-term Act, these provisions were not considered problematic. If the Internet Tax Freedom Act is to be extended, however, these provisions should be examined carefully. The provisions could be interpreted to allow a seller to avoid a collection obligation even though the seller has substantial activities and presence in the state.

The Growth of eCommerce

We support the free flow of commerce and equal competition in the marketplace. The accounting firm Ernst & Young predicts that consumers will use e-commerce for five to ten percent of retail sales in the next five years. Goldman Sachs predicts inroads of 25 percent in ten years. Even these could be significant underestimates. Business-to-business e-commerce is growing far faster than popular on-line consumer purchases. Business-to-business e-commerce is expected to reach $1.3 trillion in annual revenue by 2003, ten times the projected size of the business-to-consumer market. That's very much why the National Retail Federation, representing some 1.5 million members and nearly one in every five workers, voted last week for fairness.

It's also why my distinguished colleague Governor Gilmore's proposal would preserve business-to-business use taxes on Internet transactions. He clearly understands the enormity of the adverse impact on his budget and education and transportation commitments to the high tech businesses in Virginia were he to lose this critical source of revenues. This tax is too important not to work hard to save it in its broad application.

The Governors recognize the need to simplify the current sales and use tax collection systems to benefit the national economy through the removal of unnecessary complexity. We now have agreement by some 32 states on model state legislation and an interstate agreement through the Streamlined Sales Tax Project. States and their local government partners have taken the initiative to fashion a solution.

Tax Simplification Recommendations

States that enact the model legislation and that dramatically simplify their sales tax systems should have the authority to require out-of-state sellers to collect and remit sales and use taxes. States that do not enact model legislation would be stuck with the old ways. The fact that we have 40 states that are willing to simplify their systems and dramatically reduce the complexity and cost of collection for all sellers is evidence of our commitment to adapt to the new economy. While the project still has work to do, a model Administrative Act was completed with Wyoming the first state to approve it last month. The project will continue to refine the terms in its second phase this year.

The Wyoming simplifications, which are the same as recommended by the Streamlined Project include:

- centralized, one-stop multi-state registration;
- uniform definitions for goods and services;
- uniform rules for attributing transactions to particular taxing jurisdictions;
- uniform and simplified rules for dealing with exempt transactions;
- procedures for relieving sellers from liability to the state for errors resulting from use of information provided by states;
- certification of software that sellers may use to determine tax due on transactions;
- uniform rules for claiming bad debts;
- uniform formats for returns and remittances, including electronic filing and remittances;

- state-level administration of all state and local sales and use taxes; and,
- uniform audit procedures, including the option for a single, multi-state audit.

The Streamlined Sales Tax Project has even developed a system that would accommodate local option tax rates but, at the same time, reduce the burden of administering those rates for remote sellers and other retailers. The streamlined system would require each state participating in the system to provide sellers with a database that assigns nine-digit zip codes to taxing jurisdictions and to relieve sellers from liability for any tax not collected due to a seller's reliance on the information provided by the state. The system would also limit the frequency with which local tax rates may be changed and requires advance notice of these changes.

Wyoming Senator Mike Enzi has advocated a single blended rate for each state that would be applicable to remote commerce only. States would also have the alternative of requiring collection of the actual rate rather than the blended rate when a state has enacted all simplification measures enumerated in the bill. We support this two part approach.

The states are working to implement these simplification measures. When an appropriate number of states do agree to a common approach through an interstate compact, we expect Congress to grant states the authority to impose the duty to collect on remote vendors.

<u>Partnerships</u>

We propose a partnership between the states and the federal government to authorize the states to mandate collection and remittance of use tax by remote sellers but only for those states that have enacted the radical simplification measures recommended by the Streamlined Sales Tax Project. The Governors would favor a sales threshold below which remote sellers could not be required to collect use taxes, otherwise known as the *de minimis* provision. Collection duty would then be tied to volume of business rather than location, which is more in keeping with a free market economy.

We recommend that Internet access be defined in a fashion that achieves the Congressional goal of protecting basic access to the medium and services of the Internet without being so broad as to create inequities and distortions. The Governors recommend that the committee establish some mechanism to examine and address the issue of bundling and convergence in the near future.

The Governors recommend that Congress should use any extension of the Internet Tax Freedom Act as an important opportunity to enact legislation establishing a procedure that would encourage states and localities to continue their initiative to develop and implement a simplified and streamlined sales tax system. Those states that do simplify their sales tax systems to require remote sellers could then collect sales and use taxes on sales into a state.

The Governors support the simplifications contained in S. 521 introduced in the U.S. Senate on March 9 to reduce the burden of state and local sales tax compliance and to save the nation's economy millions of dollars through streamlining our current horse and buggy tax system. The simplifications in the bill are consistent with many of the efforts now being undertaken by the Streamlined Sales Tax Project. The project has completed what it considers the first phase of its task with the development of a model statute and accompanying agreement that states would enact to implement a much simpler multistate sales tax system. The system provides all of the simplifications contained in S. 521.

Congress should support and encourage this extraordinary effort by the states and local governments. We recommend that you authorize an interstate compact that extends the authority to require collection only to those states that simplify their tax systems. The structure embodied in S. 521 is appropriate for accomplishing this. The authority to require collection would be automatic for those states enacting the compact with the simplified structure.

Conclusion

States must be allowed to determine our own revenue policies under the laws the people of our state have adopted and we are elected to implement. Most sales taxes have been in place for at least 50 years. The system is an unwieldy horse and buggy system of another age. We are moving to fix it, to radically simplify the system so that it works.

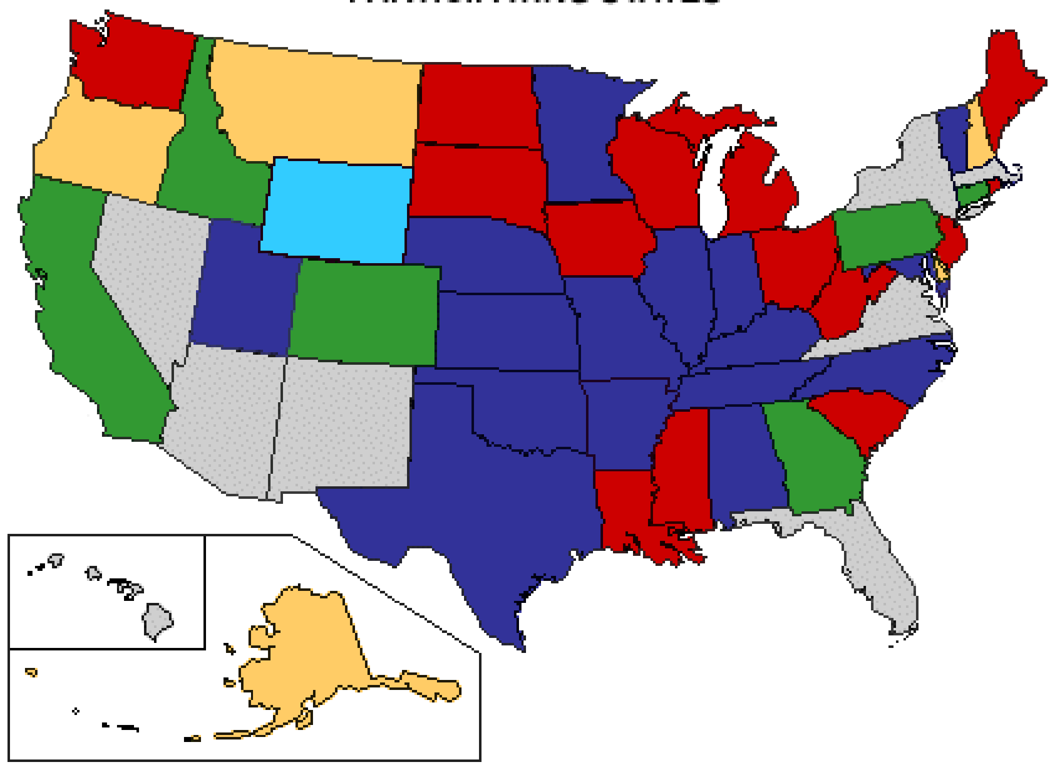
Federal Reserve Board Chairman Alan Greenspan in his remarks to the Committee on the Budget, U.S. House of Representatives, March 2, 2001 spoke of the unusually long period of economic growth in America. He spoke of technical innovation and structural productivity growth driven by individual creativity, of how the rate of growth of productivity in the past five years has far exceeded the growth rate of the previous twenty years. Much of that growth has been fueled by activity through the Internet. Chairman Greenspan pointed to the sustainability of our economic growth as being tied to Internet activity. He warned against actions by government that would discourage innovation and stifle productivity growth. Likewise, I caution this Committee against recommending an approach that would stifle the states by prohibiting certain taxes and forcing the imposition of others.

We need to let the marketplace make the decisions of which businesses succeed and which businesses fail. Let us not set arbitrary tax policies for the states at a federal level. That is wrong and unfair. That would only force people to make their decisions based on the taxing scheme and not the free enterprise system.

Thank you, Mr. Chairman, and members of the Committee for your courtesy. I would be pleased to respond to any questions or comments.

STREAMLINED SALES TAX PROJECT

PARTICIPATING STATES



- Legislation has been introduced and is pending approval
- Official* participant, but has not yet introduced legislation developed by the Project
  * State has a representative vote on Project proposals
- Adopted legislation
- Observers
- No sales tax